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# ‘Hybrid’ forms of taxing consumption: A viable alternative to EU VAT?

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## I. VAT as an indirect tax on consumption: Conceptual comparison with a RST

The great majority of value added tax (VAT) systems world-wide, including the harmonised VAT system of the European Union, have been conceived as a VAT of the consumption type. This is inherent to any VAT system that grants an immediate tax relief for all investments made by taxable business.<sup>1</sup> Ideally, the only tax burden that will not subsequently be removed from the recipient of the supply under such a system is the one imposed on supplies to final consumers. Thus, while VAT is collected at each stage of the production and distribution cycle of a product or service, the definitive tax revenue—and therefore also the final tax burden—is exactly proportional to the expenditure incurred by the final consumer for his or her purchases.<sup>2</sup> It is furthermore assumed by legal design that this final tax burden will indeed be shifted forward to the final consumers in the price of the goods or services that they acquire.<sup>3</sup> This type of VAT can therefore also be characterised as an indirect tax on personal expenditure. This is also the reason why a majority of scholars now believe that a VAT can actually be reconciled with the ability to pay principle, although it realises this principle to a lesser degree than a direct tax on income.<sup>4</sup>

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<sup>1</sup> See R van Brederode, *Systems of General Sales Taxation* (2009) Kluwer Law International 27–28; B Terra and J Kajus, *A Guide to the European VAT Directives* (2014) IBFD Publication BV, 314; A Schenk, V Thuronyi and W Cui, *Value Added Tax* (2015) Cambridge University Press, 26 et seq.

<sup>2</sup> See Art 1(2) of the European VAT Directive (Directive 2006/112/EC).

<sup>3</sup> See J English, in M Lang, P Melz and E Kristoffersson (eds), *Value Added Tax and Direct Taxation* (2009), VAT/GST and Direct Taxes: Different Purposes. IBFD Publication BV, 1–2.

<sup>4</sup> This is the predominant position among German scholars; for an overview of academic literature, see English, *ibid* 1, 22 n 90. This view is also shared by many international scholars, see Abella Poblet (Spain), *Manual del IVA* (2006) 112; Alonso González (Spain), *Fraude y delito fiscal en el IVA* (2008) 19 et seq; Amatucci (Italy), *L'Ordinamento Giuridico Della Finanza Pubblica* (2007) 82; Break (US), in Pechman (ed), *The Promise of Tax Reform* (1985) 128, 139; Casalta Nabais (Portugal), *O Dever Fundamental de Pagar Impostos* (2004) 480 et seq; Cerioni and Herrera (Italy/Spain), in Lang et al (eds), *Value Added Tax and Direct Taxation* (2009) 571, 573 et seq; Coimbra Silva (Brazil), in Silva, Bernades and Fonseca (eds), *Tributação sobre o Consumo* (2008) 321, 331; Comelli (Italy), *IVA comunitaria e IVA nazionale* (2000) 998 et seq; Herrera Molina (Spain), *Capacidad Económica y sistema fiscal* (1998) 456; Lobo Torres (Brasil), *Tratado de Direito Constitucional Financeiro e Tributário II* (2005) 310; De Mita (Italy), in Ferraz (ed), *Princípios e Limites da Tributação* 231; Mollard (Switzerland), *Archiv für schweizerisches Abgaberecht* (1994) 443, 463; Ruppe and Achatz (Austria), *Umsatzsteuergesetz* (4th ed, , 2011) para 32; Sullivan (US), *The Tax on Value Added* (1965) 4, 20; and probably also Ávila (Brasil), *Sistema constitucional*

As an indirect tax on consumption which is, ultimately, proportional to the price of goods or services consumed by households, VAT is merely an alternative method of collecting a sales tax.<sup>5</sup> Theoretically, a VAT should therefore yield the same tax revenue, and it should burden final consumers to the same extent, as a retail sales tax (RST) which is levied only at the final stage of the business chain.<sup>6</sup> In particular, both types of tax, VAT and RST, avoid the tax cascading that occurs under a classical multi-stage turnover tax, and are thus neutral regarding the organisation of business. Moreover, both a VAT and a RST allow the implementation of the destination principle which is considered to be the adequate standard for the international allocation of tax jurisdiction.<sup>7</sup>

There is one significant difference between the two types of taxing consumption expenditure, however: the RST revenue is collected only at one single stage of trade—the final one—whereas VAT is collected by way of fractionated payments made by all enterprises in a chain of business transactions:<sup>8</sup> under a VAT, the tax is paid to the treasury by each business involved in the production and trade of the good or service acquired by the final consumer, normally corresponding to the respective value added at each stage. Under the most common form of consumption type VAT, the credit-invoice VAT,<sup>9</sup> this is achieved by granting businesses a credit for the input VAT underlying their purchases of intermediate goods and services. This input VAT credit can be deducted from the taxpayer's own VAT liability, and any excess input VAT will eventually be refunded. In a VAT system, it is thus the input VAT credit that ensures neutrality of taxation for businesses.<sup>10</sup> Under a single-stage retail sales tax, the same result is obtained by excluding from the scope of the tax all sales of products and services to other business firms.

## II. Deficits of the current EU VAT system giving rise to calls for a fundamental reform

It is precisely the input VAT credit, however, that can also be considered the Achilles heel of modern VAT systems. The input VAT credit offers certain fraud opportunities which are absent in a RST system, especially because the entitlement of the business customer to the

*tributário* (3rd ed, 2007) 389 et seq; and van Hilten (Netherlands), in Albrechtse and Kogels (eds), *Selected Issues in European Tax Law* 6.

- 5 See C K Sullivan, *The Tax on Value Added* (1965) New York, Columbia University Press 5; S Cnossen, Evaluating the National Retail Sales Tax from a VAT Perspective, in Zodrow and Mieszkowski (eds), *United States Tax Reform in the 21st Century* (2002) Cambridge University Press 215, 216.
- 6 See L Ebrill, M Keen, J Bodin and V Summers, *The Modern VAT* (2001) Washington: International Monetary Fund 18–19; OECD, *Consumption Tax Trends* (2014) 21.
- 7 See OECD, *International VAT/GST Guidelines* (2006), para 4: 'the destination principle . . . is the international norm'; OECD, *Consumption Tax Trends* (2014) 24; see also A Schenk, V Thuronyi and W Cui, *Value Added Tax* (2015) Cambridge University Press 195 et seq.
- 8 See A Tait, *Value Added Tax* (1972) International Monetary Fund 19–20; S Cnossen, *EC Tax Review* (2009) 193; OECD, *Consumption Tax Trends* (2014) 19. For a different view on the collection mechanism, see R van Brederode and S Pfeiffer, VAT's Superiority: Is the Emperor Dressed like Adam? (IVM, 2015), 226, 229–230; however, van Brederode and Pfeiffer base their analysis on the final VAT burdens of the suppliers in the chain (by definition, zero in a tax on consumption), rather than on net VAT liabilities of each supplier vis-à-vis the treasury, which is what matters for an adequate description of the collection mechanism, however.
- 9 For further detail, see A Schenk, V Thuronyi and W Cui, *Value Added Tax* (2015) Cambridge University Press 28 et seq; J English, in Tipke, / Lang, *Steuerrecht* (22nd ed, 2015) § 17, para. 460 et seq.
- 10 See OECD *International VAT/GST Guidelines, Guidelines on Neutrality* (2011) para 15; I Lejeune and J Daou, VAT Neutrality from an EU Perspective, in Lang and Lejeune (eds), *Improving VAT/GST* (2014) IBFD Publication BV 459, 463–464; European Court of Justice (ECJ) 30 September 2010, case C-392/09, *Uszodaéptő*, ECR 2010, I- 8791, para 34; 12 May 2011, case C-107/10, *Enel Maritsa Iztok 3*, ECR 2011, I-3873, para 32; 28 July 2011, case C-274/10, *Commission/Hungary*, ECR 2011, I-7289, para 43.

tax credit is normally not contingent upon the prior payment of the corresponding VAT liability by the supplier. This facilitates some particular types of tax fraud not to be found in a RST environment.<sup>11</sup> A simple version is the false claim of input VAT based on forged invoices. More sophisticated fraud schemes involve a series of real or phantom taxable transactions with fraudulent intent on behalf of at least some of the traders involved: a trader may go missing after the transaction and never report or pay his VAT liability, while the recipient of the supply still claims the corresponding input VAT credit. The most commonly known of these schemes are the carousel fraud arrangements involving cross-border trade within the EU,<sup>12</sup> but they can also be found in several domestic sectors of the economy, such as in the construction sector or in scrap trade.

Beyond criminal schemes, revenue losses may also occur in VAT systems due to other reasons, depending on the design and administration of the input VAT credit. One of the problematic areas are insolvencies.<sup>13</sup> In principle, insolvencies affect the treasury like any other creditor: any as yet unpaid net VAT liability will have to be fully or partially written off. In theory, multi-stage VAT systems should diversify the treasury's exposure to the default of a taxable person to a greater degree than a RST—only the net amount of creditable input VAT incurred (and collected by the preceding taxpayer) and output VAT payable should be at risk regarding each taxpayer in the business chain, as compared with the full amount of output VAT in case of a defaulting retailer under a RST. But in the reality of the EU VAT system that is based on the accrual principle, this concept will often become flawed.<sup>14</sup> A business threatened by insolvency might still buy large quantities of goods and services and claim an immediate input VAT credit without, however, settling its debts with the suppliers before declaring itself insolvent. Under the European VAT system, the supplier may then carry out an adjustment of its VAT liability and demand a reimbursement of the VAT

<sup>11</sup> For further details, see A Tait, *Value Added Tax—International Practice and Problems* (1988) International Monetary Fund 306 et seq; PSP, *Planspiel zur systembezogenen Änderung bei der Umsatzsteuer—'Reverse-Charge-Verfahren'* (2005) 12 et seq; S Melhardt, Reverse Charge, Chancen und Risiken einer generellen Änderung des MwSt-Systems, in Quantschnigg et al (eds), *Festschrift für Wolfgang Nolz* (2008) LexisNexis 271, 274; I Lejeune and J Daou, VAT Neutrality from an EU Perspective, in Lang and Lejeune (eds), *Improving VAT/GST* (2014) IBFD Publication BV 617 et seq; see also EU Commission, *Study to Quantify and Analyse the VAT Gap in the EU Member States, 2015 Report*, TAXUD/2013/DE/321, May 2015.

<sup>12</sup> For further details, see ECJ 12 January 2006, case C-354/03 and others, *Optigen, Fulcrum und Bond House*, ECR 2006, I-483; B Spilker, *Der Leistungsempfänger als Schuldner der Mehrwertsteuer in der EU* (2006) Verlag des Wissenschaftlichen Instituts der Steuerberater 169 et seq; A González, *Fraude y delito fiscal en el IVA* (2008) MARCIAL PONS 249 et seq (Truchas y fraude carrusel); S Cnossen, Halting the Horses: EU Policy on the VAT Carousel Fraud in the EU Emissions Trading System *EC Tax Review* (2009) 192 et seq; M Tumpel, in Bizioli (ed), *Essays in International and European Tax Law* (2010) Jovene 149, 152 et seq; R Wolf, *Carrouselfraude* (2010); R Wolf, VAT Carousel Fraud: A European Problem from a Dutch Perspective, *Intertax* (2011) 26; P Efstratios, *EC Tax Review* (2012) Kluwer Law International 39; M Tumpel and G Wurm, Extension of Reverse-Charge: A Solution to Combat VAT Fraud? in Ecker, Lang and Lejeune (eds), *The Future of Indirect Taxation* (2012) Kluwer Law International 587, 593 et seq; R van Brederode and S Pfeiffer, *Combating Carousel Fraud: The General Reverse Charge VAT* (IVM, 2015) 146 et seq.

<sup>13</sup> See also W Widmann, *Umsatzsteuer-Kongress-Bericht 2001/2002* (2002) Schmidt 63, 74; J Krausel, Die Zukunft der Umsatzsteuer aus deutscher Sicht - Risiken, Chancen und Perspektiven, in *Festschrift Reiß* (2008) Schmidt 297, 307.

<sup>14</sup> See also R van Brederode and S Pfeiffer, *Combating Carousel Fraud: The General Reverse Charge VAT* (IVM, 2015) 226, 231, even though with less detail regarding the combination of factors necessary for a default to result in significant revenue losses under a VAT system, too, and with the implicit assumption that revenue losses may even be higher due to a failure to include the VAT liability on output supplies in the tax return by which input VAT is claimed.

paid to the tax authorities because it will no longer be able to retrieve this amount from its defaulting customer.<sup>15</sup> This is an adequate solution, because in VAT just like in any sales tax system, businesses act merely as tax collectors for the government and they should therefore not have to bear the risk of insolvency of their customers, at least as long as they have complied with the law and have acted in good faith. However, this leaves the tax administration with a risk of high revenue loss at every stage of the business chain (and not merely at the retail stage), since even though the input VAT deduction of the insolvent business customer may be revoked, this will normally not allow the administration to recover the ensuing higher tax liability effectively. Most of the aforementioned insolvency-related revenue losses could be prevented, though, by establishing a VAT system that links chargeability of VAT and the entitlement to the corresponding input VAT credit to the payment by the customer, rather than to the realisation of the supply.<sup>16</sup> Moreover, periods for VAT returns would have to be kept rather short.

Similar problems can arise when a court decides that an administrative practice is contrary to the law and that certain transactions which were previously treated as taxed should have been exempt, or a reverse charge should have applied. The supplier will then claim to be entitled to reimbursement of unlawfully levied VAT, whereas the recipient might be able to invoke protection of legitimate expectations in order to keep the benefit of the corresponding input VAT deduction.

Compared with a RST, a VAT furthermore may have a significant cash flow impact on business and thereby compromise the neutrality of the tax. Under the current EU rules, the VAT liability arises once the supply has been made, irrespective of whether the customer has already made a payment or not.<sup>17</sup> Under this general rule—some exceptions exist—a business must thus pre-finance the VAT revenue of the treasury before it will eventually receive the tax amount from its customer who is supposed to bear the tax burden. This is equivalent to an interest-free credit to the government required from the suppliers.<sup>18</sup> Moreover, due to fraud concerns, administrative inefficiency, or budgetary constraints of the respective government, it may sometimes take some time before businesses with excess input VAT receive an input VAT reimbursement. In some EU Member States, this may well take more than six months and cause serious cash flow issues for the affected businesses. These negative cash flow effects were also the main reasons why business representatives in the VAT Expert Group set up by the European Commission<sup>19</sup> voiced considerable reserve against reform proposals that imply a taxation of intra-Community trade of goods, which is currently still zero-rated, because only under the current zero-rating scheme can such cash flow effects be avoided for exporting businesses.<sup>20</sup> On the other hand, some firms may enjoy unfair cash flow advantages when input VAT is immediately reimbursed to them once they can procure

<sup>15</sup> See ECJ 15 May 2014, case C-337/13, *Almos Agrárkúkereskedelmi*, EU:C:2014:328, para 22.

<sup>16</sup> See S Homburg and C Rublack, Anmerkungen zum Umsatzsteuergesetzbuch, einem Vorschlag zur Umsatzsteuerreform, in Seer, Hey and J Englisch (eds), *Festschrift für Joachim Lang* (2010) Schmidt 893, 900.

<sup>17</sup> See Art 63 of the VAT Directive; B Terra and J Kajus, *A Guide to the European VAT Directives* (2014) IBFD Publication BV 725 et seq.

<sup>18</sup> See S Homburg and C Rublack, Anmerkungen zum Umsatzsteuergesetzbuch, einem Vorschlag zur Umsatzsteuerreform, in Seer, Hey and J Englisch (eds), *Festschrift für Joachim Lang* (2010) Schmidt 893, 896.

<sup>19</sup> For further details, see [http://ec.europa.eu/taxation\\_customs/taxation/vat/key\\_documents/expert\\_group/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/vat/key_documents/expert_group/index_en.htm). The author has been appointed as a member of this group since its conception in 2012.

<sup>20</sup> See also M Tumpel and G Wurm, Extension of Reverse-Charge: A Solution to Combat VAT Fraud? in Ecker, Lang and Lejeune (eds), *The Future of Indirect Taxation* (2012) Kluwer Law International 587, 604.

an invoice that has been issued to them by the supplier, even though they make a payment only at a later time. Again, most of the aforementioned unjustified effects could be removed without abandoning the VAT system as such, by linking VAT liabilities and input VAT credits to the payment by the recipient. However, some cash flow problems would still be persistent. In particular, businesses with excess input VAT might still have to wait long periods before the input VAT is eventually refunded.

Finally, businesses are faced with high compliance costs and compliance risks associated with the taxation at every stage of production and trade, and the ensuing need for an input VAT credit. Since the entitlement to an input VAT credit must usually be proven by an invoice issued by the supplier, the business customer must check whether the invoice complies with all legal requirements and the information provided therein is correct. Taxation at every stage of business also implies that sometimes difficult decisions need to be made in the international B2B trade of services as to the correct place of supply, even though in the end no revenue is at stake because the VAT charged will ultimately be credited to the business customer.

### III. Proposals for a 'hybrid' VAT aiming at a combination with RST elements

Against this background, it comes as no surprise that policymakers and academics alike have deliberated whether a VAT system would not better be replaced by some sort of approximation of the consumption tax system to a single stage retail tax. It is argued that such a reform would avoid all the negative implications of the input VAT credit, while nevertheless generating the same tax revenue and imposing the same tax burden on final consumers. When the Austrian and the German government asked for permission to introduce such a system in 2005 and 2006, respectively,<sup>21</sup> the European Commission did not want to allow only one or two Member States to introduce such a deviation from the standard VAT system as a pilot project, and it therefore objected to the two derogations requested. However, even though the Commission voiced some serious concerns, to be discussed below, it did not *a priori* reject the concept of this alternative consumption tax design as such.<sup>22</sup> And while the proposal was never realised as a broader reform project within the EU because it met resistance from a majority of Member States, the Commission nevertheless still mentioned it as an alternative to the present system in the 2011 Green Paper on the future of VAT.<sup>23</sup>

Very recently, four EU Member States (Austria, Bulgaria, the Czech Republic, and Slovakia) have made yet another attempt for a transition to a general reverse charge regime that would be equivalent to a RST while maintaining the invoice and audit trail of a VAT system.<sup>24</sup> The Commission has once more objected to the admission of such a proposal as a derogation from the current VAT system that would be limited to these four

21 See Communication from the Commission to the Council in accordance with Article 27(3) of Directive 77/388/EEC, COM(2006) 404 final; S Melhardt, Reverse Charge, Chancen und Risiken einer generellen Änderung des MwSt-Systems, in Quantschnigg et al (eds), *Festschrift für Wolfgang Nolz* (2008) LexisNexis 271, 279; M Tumpel and G Wurm, Extension of Reverse-Charge: A Solution to Combat VAT Fraud? in Ecker, Lang and Lejeune (eds), *The Future of Indirect Taxation* (2012) Kluwer Law International 587, 600–602.

22 See EU Commission, Press Release IP/06/1023, of 19 July 2006; accessible at [http://europa.eu/rapid/press-release\\_IP-06-1023\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-06-1023_en.htm?locale=en).

23 See EU Commission, Green Paper on the future of VAT of 1 December 2010, COM(2010) 695 final, 8–9.

24 See Communication from the Commission of 28 October 2015, COM(2015) 538 final.

countries on similar grounds as it did in 2006, but it was even more cautious about the possible drawbacks and merits of such a fundamental change than ten years ago.<sup>25</sup> Some officials have indicated that the broader implications of the proposal will continue to be debated in other Union fora. The issue therefore remains high on the agenda of European VAT reform.

Currently, only a few countries still have a general retail sales tax in their tax system. The best-known of those few exceptions are the United States, where the great majority of sub-federal states impose a retail sales tax on goods.<sup>26</sup> However, the United States retail sales taxes are rather imperfect because they fail consistently to exempt all B2B transactions, they do not cover all goods and hardly any services, and they do not fully implement the destination principle.<sup>27</sup> Therefore, models that would effectively come closer to a more sophisticated retail sales tax have been devised as an alternative to the VAT system and as a possibility of avoiding the problems surrounding the input VAT credit. Two of the most detailed reform proposals in this regard have been conceived in Germany. The following deliberations will focus on these two concepts, not the least because one of them also forms the basis of the aforementioned 2005/2006 and 2015 reform initiatives. The proposals have in common that they seek to avoid the need for input VAT credits and emulate the tax effects that would actually occur under a single stage retail tax, while at the same time keeping the invoice and audit trail that is inherent to a multi-stage VAT system.<sup>28</sup>

The first proposal is the so-called 'Mittler model',<sup>29</sup> which was originally developed by the state finance ministry in the state of Rhineland-Palatinate in the early years of the new millennium. This proposal also formed the backbone of the joint German–Austrian 2006 reform initiative at the EU level, and it is still inspiring the current push by Austria and other Member States for a fundamental change of VAT design. According to the original version of the Mittler-model, all businesses entitled to a full input VAT deduction should be issued a special identification number which would be administered electronically. When procuring goods and services from other taxable businesses, the business customer could claim to be entitled to receive supplies free of VAT (zero-rated) upon presentation of the identification number. The supplier should then check the number in real time by accessing an online database to be maintained by national tax administrations or by a European agency. After confirmation of validity, the sale could be made net of VAT. In this original version of the Mittler proposal, it was assumed that the recipient of the supply would neither incur a VAT liability himself, nor would her business be entitled to any input VAT credit.

Subsequently, the state and federal finance ministers who endorsed the core idea of eliminating the classical concept of charging VAT on B2B transactions from the supplier and

<sup>25</sup> See Communication from the Commission of 28 October 2015, COM(2015) 538 final, 4.

<sup>26</sup> For a detailed description, see W Hellerstein, *State and Local Taxation* (10th ed, 2014) West, St. Paul.

<sup>27</sup> For details, see R van Brederode, *Systems of General Sales Taxation* (2009) Kluwer Law International 73 et seq.

<sup>28</sup> See also S Cnossen, *EC Tax Review* (2009) 192–193, regarding the German-Austrian proposal of 2006 which was based on refinements of the Mittler model.

<sup>29</sup> See G Mittler, *Umsatzsteuer-Rundschau* (2001) 385 et seq; G Mittler, *Umsatzsteuer-Rundschau* (2004) 1 et seq; W Widmann, *Umsatzsteuer-Rundschau* (2002) 14 et seq; W Widmann, *Umsatzsteuer-Kongress-Bericht 2001/2002* (2002) Schmidt 63 et seq. For conceptually similar proposals, see also M Tumpel, *A Hybrid VAT System in the European Union* (2007) 47 *Tax Notes international* 165 et seq; R van Brederode and S Pfeiffer, *Combating Carousell Fraud: The General Reverse Charge VAT (IVM, 2015)* 146 et seq.

granting an input VAT credit to the customer made some modifications and refinements:<sup>30</sup> most importantly, it was suggested that B2B transactions should also continue to constitute chargeable events, but instead of the supplier it should be the eligible business customer who would be liable for payment of VAT under a general reverse charge procedure. Normally, this would not result in any real VAT payment because a corresponding input VAT credit could immediately be claimed and offset against the VAT liability. But this modification would allow the imposition of a tax burden on businesses using the input supplies for exempt transactions. However, businesses with more than 90% exempt supplies would not qualify for a reverse charge transaction, because they could not receive the special identification number needed to trigger the reverse charge method.<sup>31</sup> Here, the traditional approach of vendor tax collection would still apply.

Under both alternatives, cross-checks to be carried out by the tax administration should be facilitated by obliging the supplier to notify tax authorities online about each individual tax-free sale. Business customers would in turn have to periodically inform authorities about the total amount of tax-free input supplies that they have received. In order to minimise opportunities for fraud by final consumers pretending to be businesses eligible for a VAT-free supply, it was suggested that the traditional VAT system should be maintained for sales below a threshold of 5,000 euro.<sup>32</sup> Effectively, the system would thus become a 'hybrid' one:<sup>33</sup> B2C transactions and some B2B supplies would still be taxed as under a classical VAT, whereas the bulk of B2B transactions above the threshold would be subject to reverse charge.

Ten years later, Paul Kirchhof and a team of researchers developed a second reform proposal.<sup>34</sup> It was inspired by the Mittler model, but Kirchhof was intent on making it more robust against fraud opportunities while at the same time replacing the current VAT system even for small purchases. To that effect, Kirchhof favoured an approach whereby B2B sales could only be realised free of tax (as out-of-scope transactions) if certain formal conditions were met. First, it should again be a requirement for the buyer to present a business identification number to be issued to each taxable business by the respective national tax administration. Secondly, and this is the novelty, the sale would only be free of VAT if the payment were made by way of bank transfer from the customer to the supplier. Both sides were expected to use designated accounts for this purpose, which could be inspected by the tax authorities upon request to allow for better controls. Cash payments in particular would therefore not qualify for a tax free supply; instead the traditional system of charging VAT and of a corresponding input VAT credit should still

<sup>30</sup> See Finanzministerkonferenz, *Umsatzsteuer-Rundschau*, 2005) 662. For a detailed description, see P Matheis and S Groß, Best of Both Worlds? – Lösungsansätze zur Ausgestaltung und Umsetzung des Reverse-Charge-Verfahrens *Umsatzsteuer-Rundschau* (2006) 379 et seq; J Kraeusel, in *Festschrift Reiß* (2008) Schmidt 297, 309 et seq.

<sup>31</sup> See also R van Brederode and S Pfeiffer, Combating Carousel Fraud: The General Reverse Charge VAT (IVM, 2015) 146, 153, who suggest that only fully exempt businesses should be disqualified from obtaining a VAT ID.

<sup>32</sup> See also S Melhardt, Reverse Charge - Chancen und Risiken einer generellen Änderung des MwSt-Systems in Quantschnigg et al (eds), *Festschrift für Wolfgang Nolz* (2008) LexisNexis 271, 277, who suggests a threshold of 10,000 euro. This amount corresponds to the one proposed in the 2005 and 2015 Austrian derogation request mentioned above.

<sup>33</sup> See M Tumpel and G Wurm, Extension of Reverse Charge: A Solution to Combat VAT Fraud? in Ecker, Lang and Lejeune (eds), *The Future of Indirect Taxation*, (2012) Kluwer Law International 587, 598.

<sup>34</sup> See P Kirchhof, *Umsatzsteuer Gesetzbuch* (2008) C.F. Müller; P Kirchhof, *Bundessteuergesetzbuch* (vol 4: Umsatzsteuer, 2011) C.F. Müller.



apply. The same would be true for any other means of payment, such as debit or credit cards, because in this case, too, it would not be possible to enter the business ID number and the invoice number into the account trail controlled by the tax authorities. It is assumed by Kirchhof and his team, however, that payments other than by bank transfer would become an exception in the new system. They would therefore alert tax authorities and provoke audits or other investigations that should allow for a fast detection of possible fraudulent activities.

Small businesses below the registration threshold that only make exempt supplies should not receive an identification number, and they should therefore be treated like final consumers in order to ensure an input VAT burden on their supplies. In case of abuse of an identification number by a final consumer or by a businessperson making purchases for private purposes, a supplier acting in good faith should nevertheless be allowed to treat the supply as VAT-free if he relied on an online verification of the business identification number that was carried out before the supply was made. Finally, every supplier would be required to notify the tax authorities in monthly returns about her business customers and the value of the supplies made to each customer.

#### IV. Critical analysis of two detailed proposals

Both reform proposals have their merits but also especially their weaknesses, which are essentially inherent to any kind of model that is tantamount to establishing a retail sales tax mechanism where B2B transactions are no longer taxed.

##### 1. Fraud robustness

Obviously, both proposals, if implemented, would greatly reduce opportunities for missing trader and carousel fraud and similar criminal schemes.<sup>35</sup> Such schemes would still be possible to some extent because under both models the input VAT credit would still be granted in some situations, as explained above. However, large input VAT deductions would become uncommon and would therefore raise suspicion of tax authorities, hence the schemes would become much riskier and less lucrative. Claiming input VAT based on counterfeit invoices would become less attractive—but also not entirely eliminated—for similar reasons. Revenue losses due to insolvencies or other situations where subsequent adjustments of the original tax treatment become necessary would also decrease<sup>36</sup> because, in most instances, there would no longer be any tax effectively levied in the first place.

<sup>35</sup> See also A Gebauer, C W Nam and R Parsche, Can Reform Models of Value Added Taxation Stop the VAT Evasion and Revenue Shortfalls in the EU? (2007) *Journal of Economic Policy Reform* 1, 10; D Kempf, Die Einführung des Reverse-Charge-Verfahrens als Möglichkeit der Bekämpfung von Umsatzsteuerausfällen und seine praktischen Probleme, in *Festschrift Reiß* (2008) 275, 285; S Melhardt, in Quantschnigg et al (eds), *Reverse Charge - Chancen und Risiken einer generellen Änderung des MWSt.-Systems Festschrift für Wolfgang Nolz* (2008) LexisNexis 271, 274.

<sup>36</sup> See J Kraeusel, Die Zukunft der Umsatzsteuer aus deutscher Sicht - Risiken, Chancen und Perspektiven in *Festschrift Reiß*, (2008) Dr. Otto Schmidt 297, 312–314; A Gebauer, C W Nam and R Parsche, Can Reform Models of Value Added Taxation Stop the VAT Evasion and Revenue Shortfalls in the EU? (2007) *Journal of Economic Policy Reform*, Taylor & Francis 1, 10.

However, these benefits would be accompanied by fraud opportunities and revenue risks of a different kind<sup>37</sup> which are much less relevant in the current VAT system. Since B2B transactions would no longer give rise to a tax liability of the supplier, individual entrepreneurs or their employees would have an incentive to misuse a business ID for private purchases.<sup>38</sup> An even greater concern is that ordinary final consumers might try to pretend to run a business in order to obtain a business ID, which they would then use in order to make purchases free of tax, or use business ID numbers of former entrepreneurs that have not as yet been removed from the system.<sup>39</sup> Even false ID numbers could be used if the supplier fails to verify the business ID online. In fact, all of this happened in Germany under the old, not yet harmonised turnover tax system, when exemptions for wholesale trade and resellers were made available in order to reduce tax cascading. The American sales tax system is also reported to have a significant ‘excess registration’ problem, even though average tax rates are only 7% compared with 20% as in the EU. It is therefore doubtful whether tax authorities could effectively prevent this kind of massive final consumer fraud from happening, especially in some Member States with relatively lax tax enforcement standards.

Admittedly, both of the models described above seek to minimise this danger by relying on thresholds for VAT-free supplies (the Mittler model and its subsequent modifications)<sup>40</sup> or by limiting such supplies to payments made by bank transfer (the Kirchhof model). But the latter approach especially might not be very effective, and both restrictions add complexity to the system for businesses.<sup>41</sup> Moreover, both proposals certainly impose significant compliance costs and risks on the supplier in this regard, because she must either constantly verify business ID numbers and customer identity, or accept the risk of being held accountable for any VAT not charged.

## 2. Cash flow effects

Both reform proposals would, at least at first sight, significantly reduce liquidity burdens on business:<sup>42</sup> since VAT liabilities in B2B trade would become the exception, the current

<sup>37</sup> See Communication from the Commission to the Council in accordance with Article 27(3) of Directive 77/388/EEC, COM(2006) 404 final, p. 7; A Gebauer, C W Nam and R Parsche, Can Reform Models of Value Added Taxation Stop the VAT Evasion and Revenue Shortfalls in the EU? (2007) *Journal of Economic Policy Reform* 1, 10; S Cnossen, *EC Tax Review* (2009) 194–195.

<sup>38</sup> See R van Brederode and S Pfeiffer, VAT’s Superiority: Is the Emperor Dressed Like Adam? (IVM 2015) 226, 229. The authors doubt, though, that business owners would be significantly more inclined to engage into this kind of fraudulent behaviour, as compared with making false statements about the actual (private) use of their purchases in their tax returns under the current regime, and thereby fraudulently claiming an input VAT deduction; see R van Brederode and S Pfeiffer, VAT’s Superiority: Is the Emperor Dressed Like Adam? (IVM 2015) 226, 233.

<sup>39</sup> See also S Melhardt, in Quantschnigg et al (eds), *Reverse Charge - Chancen und Risiken einer generellen Änderung des MWSt.-Systems Festschrift für Wolfgang Nolz* (2008) LexisNexis 271, 276.

<sup>40</sup> This is emphasized by M Tumpel and G Wurm, *Extension of Reverse-Charge: A Solution to Combat VAT Fraud?* in T Ecker, J Lang and I Lejeune (eds), *The Future of Indirect Taxation* (2012) Kluwer Law International 587, 598–599 and 602.

<sup>41</sup> For a similar assessment of the transaction-related thresholds, see R van Brederode and S Pfeiffer, *Combating Carousel Fraud: The General Reverse Charge VAT* (IVM 2015). 146, 156. Their alternative proposal (*ibid* 154) of setting a high registration threshold (similar to the current small business exemption in EU Member States, but at 100,000 to 200,000 euro of annual turnover) is in all likelihood not as effective as a per-transaction threshold in curbing micro fraud, and it has additional disadvantages. In particular, it implies significant VAT revenue losses and distortions of competition.

<sup>42</sup> See also R van Brederode and S Pfeiffer, *Combating Carousel Fraud: The General Reverse Charge VAT* (IVM 2015) 146, 153: Avoidance of cash flow disparities.

negative cash flow effects associated with VAT payment obligations arising before customer payments are received, as described above, would be significantly reduced. In a similar vein, excess input VAT credits would, seemingly, become less frequent and slow reimbursements less of a problem. As a further consequence, a higher degree of neutrality between intra-Community supplies and domestic supplies would be achieved with a view towards their respective cash flow effects, whereas currently distortions arise from the fact that (only) the former are zero-rated.

Theoretically, the same effect could be achieved to a large extent also within the present VAT system. It would only be necessary, as already explained above, to link VAT liability and input VAT credits to actual cash flows, and to provide for speedy assessments of input VAT credit claims. If the latter cannot be achieved, a second-best solution could be to allow factoring of VAT refunds, or to pay interest on belated refunds. But, admittedly, negative cash flow effects can more easily be avoided if no tax is levied in the first place, especially if the tax administration is inefficient or overly formalistic in its relationships with the taxpayers. So, the reform proposals appear to score higher in this regard.

There is one important caveat, though, as the European Commission has correctly pointed out.<sup>43</sup> In some instances and especially in case of small value purchases, input VAT would still be incurred by businesses, either because they have made an acquisition below the threshold (the Mittler model/reverse charge model), or because they have not used bank transfer (the Kirchhof model). However, some of the businesses with such occasional input VAT burdens would no longer be able to offset the input tax with their output VAT liability, because the bulk or all of their B2B output would remain untaxed (the Mittler model/reverse charge model) or would be tax free transactions (the Kirchhof model). This could result in an increase in the number of excess input VAT positions and, consequently, VAT refund claims. Thus, negative cash flow effects would again be entering the system ‘through the back door’ and, moreover, tax authorities would have to spend considerable resources on checking numerous albeit small input VAT refund claims.

### 3. Compliance/administrative costs and risks

Also regarding the aspect of compliance costs and compliance risks, the reform proposals leave a mixed impression, at best. On the positive side, invoices—while still required—would no longer be relevant for claiming an input VAT credit any more to the extent that B2B transactions are tax free under the reform proposals. Hence, compliance risks are reduced as compared with the current system, where the recipient of the supply must ensure that the invoice is complete and correct in order to be relieved from the input VAT burden. Some other compliance costs would also be eliminated, namely those associated with taxing B2B transactions at the right place and at the appropriate rate (provided that the recipient has a full right to deduct input VAT). However, different from a pure—theoretical—RST,<sup>44</sup> manufacturers, wholesale traders, and other businesses that exclusively carry out B2B supplies would nevertheless still have to register as taxable persons and comply with reporting requirements.

<sup>43</sup> See Communication from the Commission on measures to change the VAT system to fight fraud, COM(2008) 109 final, 8.

<sup>44</sup> See, in this regard, R van Brederode and S Pfeiffer, VAT’s Superiority: Is the Emperor Dressed Like Adam? (IVM 2015) 226, 228.

Moreover, along with the approximation towards a retail sales tax come other severe compliance costs and risks that are unknown or less burdensome in the current VAT system.<sup>45</sup> If consumption is taxed by levying a VAT, suppliers making domestic supplies normally need not care about their customer's status—business or final consumer—because VAT is chargeable either way.<sup>46</sup> By contrast, in a retail sales tax this distinction is crucial and it requires suppliers to verify a customer's business ID number.<sup>47</sup> Moreover, both alternatives discussed above require detailed information in monthly returns about each and every reverse-charged or tax-free transaction to be submitted by the supplier (and, in case of the Mittler model, also information required from the business customer), in order to allow for cross-checks to be carried out by tax authorities.<sup>48</sup> The scope and level of detail of the so-called recapitulative statements, which are currently only required for cross-border transactions pursuant to Article 262–271 VAT-D, would thus be massively broadened.<sup>49</sup> Empirical evidence from other countries that have introduced such a system suggests that it significantly increases compliance costs for business and is also administratively burdensome; moreover, due to the sheer size of information to be processed, it is prone to errors.<sup>50</sup> The procedure is thus not only costly, but also not very efficient unless complemented by a sophisticated risk management system.

The tax administration would furthermore face significant administrative costs in monitoring whether or not tax-free supplies have really been used for business purposes,<sup>51</sup> and it would have to make considerable efforts to keep the online database of VAT ID numbers updated and eliminate any fraudulent or inactive persons from it.<sup>52</sup> It is well-known that even in the EU some Member States already have great difficulties in ensuring the integrity of their databases of registered businesses. If a business registration were to become an attractive instrument of VAT evasion for a much broader potential group of small-scale tax fraudsters, their national tax administrations would likely be overwhelmed.

45 See S Homburg and C Rublack, Anmerkungen zum Umsatzsteuergesetzbuch, einem Vorschlag zur Umsatzsteuerreform, in *Festschrift für Joachim Lang* (2010) Dr. Otto Schmidt 893, 896.

46 See S Melhardt, Reverse Charge - Chancen und Risiken einer generellen Änderung des MWSt.-Systems in Quantschnigg et al (eds), *Festschrift für Wolfgang Nolz* (2008) LexisNexis 271, 274.

47 See Communication from the Commission on measures to change the VAT system to fight fraud, COM(2008) 109 final, 8; S Cnossen, *EC Tax Review* (2009) Kluwer Law International 193; B Terra and J Kajus, *A Guide to the European VAT Directives* (2014) IBFD 308–309. This is also regarded as a minimum requirement (eventually even to be complemented by additional safeguards, e.g. in case of cash payments or the sale of typical consumer goods) by R van Brederode and S Pfeiffer, *Combating Carousel Fraud: The General Reverse Charge VAT* (IVM, 2015) 146, 153–154, and also in n 45).

48 See also R van Brederode and S Pfeiffer, *Combating Carousel Fraud: The General Reverse Charge VAT* (IVM, 2015) 146, 153.

49 For a different suggestion regarding a transition to a general reverse charge system, see S Melhardt, *Reverse Charge - Chancen und Risiken einer generellen Änderung des MWSt.-Systems*, in Quantschnigg et al (eds), *Festschrift für Wolfgang Nolz* (2008) LexisNexis 271, 282: recapitulative statements should be sufficient.

50 See G Harrison and R Krellove, 'VAT Refunds: A Review of Country Experience', IMF Working Paper No 05/218; Kempf, *Die Einführung des Reverse-Charge-Verfahrens als Möglichkeit der Bekämpfung von Umsatzsteuerausfällen und seine praktischen Probleme*, in *Festschrift Reiß* (2008) Dr. Otto Schmidt 275, 289–290.

51 See Communication from the Commission on measures to change the VAT system to fight fraud, COM(2008) 109 final, 9.

52 See also R van Brederode and S Pfeiffer, *Combating Carousel Fraud: The General Reverse Charge VAT* (IVM, 2015) 146, 153: 'in the current system of VAT ID issuance [the scrutiny of VAT ID requests] plays a very minor role. Enhancing such processes would require time and manpower to determine the status of taxable persons beforehand'.

Moreover, the VAT method accommodates better for an exemption of small firms than the reform proposals. Under a VAT, any small business below the registration threshold is simply denied an input VAT credit whereas, under the single-stage approach, suppliers need to check and verify whether the business they are dealing with is a registered one or falls below the threshold.

The reform would also introduce additional complexity into the system with regard to the taxation of suppliers who carry out exempt supplies. Under the modified Mittler proposal (the general reverse charge model), such suppliers would be liable for the VAT on their corresponding input supplies according to the reverse charge method, while they would be entitled to no or only a partial input VAT credit, and they would thus have to remit VAT to the tax authorities. This would significantly increase tax reporting obligations for many taxpayers. Admittedly, the proposal would not go so far as to require the myriad of businesses that currently are not registered for VAT purposes, such as landlords who provide exempt leasing on letting of residential housing, doctors offering exempt medical care, educational institutions, etc, to file periodical VAT returns. This is avoided by disqualifying businesses with more than 90% exempt turnover from participation in the reverse charge scheme. However, this threshold adds complexity to the system, since it requires periodical monitoring by the affected businesses and tax authorities. Moreover, to the extent that changes in the business activities are not immediately reflected in its status, the exception could be misused for the continuation of missing trader fraud. Under the Kirchhof proposal, the problem is not even addressed because Kirchhof argues that exemptions should be altogether abolished.<sup>53</sup> While this is generally desirable from a theoretical perspective,<sup>54</sup> such an assumption is highly unrealistic, though.

Finally, historical experience shows that under a VAT, the bulk of tax revenue is collected from a few 'large players' within the economy, even though the exact figures may vary over time and regionally.<sup>55</sup> For example, it has been stated that more than 80% of all VAT revenue in EU Member States is levied from less than 10% of all registered businesses.<sup>56</sup> A great proportion of those large businesses will normally be manufacturers, wholesalers, or other businesses that exclusively or predominantly engage in B2B trade. The VAT system of fractionated payments throughout the chain of businesses allows tax authorities to target these large taxpayers and concentrate their auditing efforts on a rather small number of firms where most revenue is at stake. For some developing countries, this is in fact the only reliable source of consumption tax revenue, because their tax administrations are not capable of monitoring smaller taxpayers.<sup>57</sup>

<sup>53</sup> See P Kirchhof, *Bundessteuergesetzbuch* (vol 4: Umsatzsteuer, 2011) C. F. Müller § 111 para 1: only a few zero-rated categories of supplies would remain.

<sup>54</sup> See J Englisch, The EU Perspective on VAT Exemptions, in R de la Feria (ed), *VAT Exemptions* (2013) Wolters Kluwer Law & Business 37, 60 et seq).

<sup>55</sup> See S Homburg and C Rublack, Anmerkungen zum Umsatzsteuergesetzbuch, einem Vorschlag zur Umsatzsteuerreform in *Festschrift für Joachim Lang* (2010) Dr. Otto Schmidt 893, 898–899. This is questioned, but without any empirical underpinnings, by M Tumpel and G Wurm, Extension of Reverse-Charge: A Solution to Combat VAT Fraud? in T Ecker, J Lang, I Lejeune (eds), *The Future of Indirect Taxation* (2012) Kluwer Law International 587, 603.

<sup>56</sup> See S Cnossen, *EC Tax Review* (2009) Kluwer Law International 194; see also A Tait, *Value Added Tax—International Practice and Problems* (1988) International Monetary Fund 19, regarding the Norwegian VAT system: 90% of all VAT revenue was collected by less than 20% of all registered businesses at that time.

<sup>57</sup> Regarding the importance of taxing B2B imports, in particular, see A Tait, *Value Added Tax—International Practice and Problems* (1988) International Monetary Fund 19; L Ebrill, M Keen, J P Bodin and V Summers, *The Modern VAT* (2001) 49; OECD, *Consumption Tax Trends* (2014) International Monetary Fund 21–22.

In economic reality, this is also not merely a zero-sum game, as could theoretically be argued by assuming that an increased VAT liability (for the 'large players') should always be accompanied by a corresponding increase in input VAT deduction for the business customer, so that it would always be (only) the retail stage that ultimately matters for definitive VAT revenues. First, in almost all VAT systems and certainly in the European one, large sectors of the economy are not entitled to a full input VAT deduction. Secondly, in certain sectors of the economy small businesses may be inclined to commit VAT fraud by under-reporting both input and output transactions. In either event, including businesses with a large B2B customer base among taxable persons, and ensuring correct taxation of B2B transactions carried out by large businesses in general, will reduce revenue leakage when small and medium size business customers are monitored and audited with less scrutiny.

By contrast, in a system that collects the tax only at the retail stage, more audits would be needed and thus significantly higher administrative costs would be incurred in order to obtain effectively the same amount of definitive VAT revenue.<sup>58</sup> Moreover, and more fundamentally, it would be crucial that tax authorities are sufficiently staffed, equipped, motivated, and incorruptible in order to enforce VAT liabilities effectively also vis-à-vis small and medium-sized businesses.<sup>59</sup>

## V. Conclusions

Taking all the above into consideration, it is far from clear that replacing the current VAT system with input VAT credit by a system more aligned to the concept of a single stage retail sales tax would be a preferable tax policy choice for the EU.<sup>60</sup> Extensive economic analysis and simulations are needed to assess whether such a new system might not actually be even less robust against tax fraud than the current one, taking into account the administrative realities in all 28 Member States. Furthermore, the additional complexity, cash flow aspects, as well as compliance and administrative costs permanently ensuing from a system change need to be more thoroughly assessed and quantified.

It therefore would appear to be advisable to pursue a two-track strategy. Possible improvements within the current VAT system with a view towards combatting fraud more efficiently, enhancing VAT neutrality, and reducing compliance and administrative costs should still be explored. At the same time, alternative methods of taxing final consumption that seek to eliminate taxation of B2B transactions, at least in principle, should be further researched. The EU Commission is determined to engage in the former exercise, albeit only in the medium term.<sup>61</sup> The recent initiative by four Member States to rekindle the discussion about a more fundamental change of the VAT system, towards a 'hybrid' system with a general reverse charge, will likely also spur the EU institutions into exploring such alternative routes more profoundly, too.

<sup>58</sup> See Communication from the Commission on measures to change the VAT system to fight fraud, COM(2008) 109 final, 8–9.

<sup>59</sup> See also R van Brederode and S Pfeiffer, Combating Carousel Fraud: The General Reverse Charge VAT (IVM, 2015), 146, 153: The general reverse charge system 'is tailored to developed countries with efficient tax authorities'.

<sup>60</sup> For a skeptical assessment, see also A Gebauer, C W Nam and R Parsche, (2007) *Journal of Economic Policy Reform* 1, 3; W Reiß, in R Seer (ed), *Die harmonisierte Umsatzsteuer im nationalen Wirtschaftsverkehr - Widersprüche, Lücken und Harmonisierungsbedarf Umsatzsteuer im Europäischen Binnenmarkt* (DStJG 32, 2009) 9, 26.

<sup>61</sup> See J Englisch, Conclusions to be drawn - Possible next steps - Directions for future work (2015) *World Journal of VAT/GST Law* 55, 67.